Seattle Public Utilities—
Water Fund
(An Enterprise Fund of the City of Seattle)

Financial Statements and Additional Information
for the Years Ended December 31, 2002 and 2001,
and Independent Auditors' Report

SEATTLE PUBLIC UTILITIES—WATER FUND

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INDEPENDENT AUDITORS' REPORT

Director
Seattle Public Utilities—Water Fund
Seattle, Washington

We have audited the accompanying balance sheets of the Seattle Public Utilities—Water Fund (the "Fund") as of December 31, 2002 and 2001, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the financial statements, in 2002 the Fund adopted Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*; and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*.

The accompanying management's discussion and analysis on pages 2 through 4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Deloitte & Touche LLP

April 2, 2003

SEATTLE PUBLIC UTILITIES—WATER FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED DECEMBER 31, 2002

The financial statements contained in this report document the financial performance of the Water Fund of Seattle Public Utilities. The revenues, expenses, assets, and liabilities of Seattle's water system are recorded in the Water Fund. The financial situation of other aspects of Seattle city government, including other utility services and general government operations, are reported elsewhere.

This section of the report summarizes the financial situation of the Water Fund, especially with respect to changes since 2001.

SUMMARY STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

The following statements of revenues, expenses, and changes in net assets present the annual surplus or deficiency of revenues over expenses (the change in net assets):

	2002	2001
Operating revenues	$ 118,160,130	$ 105,345,317
Operating expenses	90,862,948	86,346,768
Net operating income	27,297,182	18,998,549
Other expenses	(24,257,765)	(19,585,237)
Loss on Tacoma Project	(6,636,051)	
Capital and operating fees, contributions, and grants	6,167,043	5,470,681
Change in net assets	$ 2,570,409	$ 4,883,993

In 2002, the water system experienced net income of $2.6 million. Net income in 2002 was somewhat lower than in 2001, principally because of a $6.6 million loss recorded on a water supply project known as the Tacoma Project. This supply project was a partnership with the City of Tacoma and several other utilities to expand the supply system of Tacoma and build a pipeline to deliver a portion of the expanded supply to Seattle. Over the last decade, Seattle has paid approximately $6.6 million of preliminary project costs. Seattle will no longer participate in the project, so this $6.6 million was written off as an expense in 2002. 2002 water demand of 137 MGD (millions of gallons of water per day) is far less than the 171 MGD firm yield of the supply system, so participation in the Tacoma Project is not necessary to ensure water supply in the near term.

Operating revenues were $12.8 million higher in 2002 than 2001. These additional revenues were generated primarily from rate increases effective January 1 and September 16. An additional 10.6% rate increase has been adopted, effective January 1, 2004. Total operating expenses were $4.5 million higher in 2002 than 2001, of which $1.5 million was due to increased depreciation and amortization expenses resulting from capital investments and $0.9 million was due to increased revenue tax payments. Due to the lateness of rains that normally refill supply reservoirs, standby pumping plants and wellfields were mobilized to ensure adequate water supply. This mobilization added $1.4 million to field operations costs in 2002.

Other expenses also increased by $4.7 million, of which $2.0 million was increased interest expense, $1.4 million was decreased land sales revenue, and $1.1 million was decreased interest earnings on cash and investments. Interest expenses are expected to continue to increase, reflecting substantial debt financing of the capital program. Land sales revenue and interest earnings are expected to vary from year to year.

SUMMARY BALANCE SHEETS

The following summary balance sheets present the assets of the water system and show the mix of liabilities and net assets used to acquire these assets:

	2002	2001
Assets:		
Current assets	$ 28,621,081	$ 26,327,941
Noncurrent assets:		
Utility plant—net	848,137,209	783,001,388
Other	64,110,534	76,467,497
Total assets	940,868,824	885,796,826
Liabilities:		
Current liabilities	46,052,101	39,077,509
Noncurrent liabilities:		
Long-term debt	622,766,292	577,187,288
Other	8,403,057	8,455,064
Total liabilities	677,221,450	624,719,861
Net assets:		
Invested in capital—net of related debt	$262,152,705	$259,318,696
Unrestricted	1,494,669	1,758,269
Total net assets	$263,647,374	$261,076,965

Assets**—**Current assets increased by approximately $2.3 million, largely due to increases in accounts receivable. The standing balance of accounts receivable has increased because rates and direct service and wholesale revenues have increased. Most of the $12.4 million reduction in other assets reflects lower year-end construction fund cash balances in 2002 than in 2001. Construction fund cash balances vary from year to year depending upon the amount of new debt issued and the level of debt-funded capital investment.

Significant capital spending of $92.4 million increased net utility plant (including work in progress) by approximately $65.1 million. Of this, $35.7 million was construction of a new treatment plant on the Cedar River source of supply that is expected to be complete in 2004. The remaining $56.7 million in capital acquisitions include pipeline, conservation, and distribution system improvements, including $7.7 million in projects related to the Cedar River Habitat Conservation Plan. Large capital investments are expected to continue. Over the next six years, the adopted capital improvement program totals $612.8 million, and includes $40.4 million to complete the treatment plant on the Cedar River and $133.4 million to bury above-ground reservoirs.

Liabilities**—**Current liabilities increased by approximately $6.9 million, of which $2.0 million is due to revenue bonds due in 2003. This increase in debt service payments reflects ongoing debt financing of a substantial capital program. Accounts payable increased by $4.7 million associated with capital program costs accrued at year end. The amount of these accrued costs varies annually with the invoices received from contractors.

Long-Term Debt—In 2002, $65.0 million in revenue bonds were issued to finance the water system capital program. These bonds were insured and rated Aaa by Moody's and AAA by Standard & Poor's. The water system's underlying bond rating continues to be Aa2 and AA respectively, with a stable outlook. This bond issue, net of the bonds retired in 2002, is responsible for the $45.6 million increase in the water system's long-term debt liability. The water system expects to continue to finance a large portion of its capital program with revenue bonds in the near term.

Net Assets—Net assets are the portion of the assets of the water system no longer financed with revenue bonds or other liabilities. Net assets increased by $2.6 million from 2001 to 2002.

SEATTLE PUBLIC UTILITIES—WATER FUND

BALANCE SHEETS
DECEMBER 31, 2002 AND 2001

ASSETS	2002	2001
CURRENT ASSETS:		
Cash and equity in pooled investments	$ 3,990,918	$ 1,254,645
Rate Stabilization Account—cash and equity in pooled investments		3,000,000
Accounts receivable, net of allowances for doubtful accounts of $148,268 and $133,756	10,528,750	8,587,663
Unbilled revenues	7,076,983	6,444,933
Current portion of notes and contracts receivable	91,618	86,615
Due from other City funds	724,880	1,655,192
Due from other governments	1,366,745	778,299
Materials and supplies inventory	4,827,185	4,508,735
Prepayments and other	14,002	11,859
	28,621,081	26,327,941
RESTRICTED ASSETS:		
Bond Parity Account—cash and equity in pooled investments	3,052,300	137,095
Construction Fund:		
Cash and equity in pooled investments	19,430,360	1,415,666
Investments		33,578,241
Vendor deposits—cash and equity in pooled investments	676,460	945,575
	23,159,120	36,076,577
DEFERRED CHARGES AND OTHER:		
Unamortized bond issue costs—net	4,630,763	4,658,777
Notes and contracts receivable	710,013	801,631
Deferred conservation costs—net	13,273,045	10,897,135
Other deferred charges	22,337,593	24,033,377
	40,951,414	40,390,920
UTILITY PLANT—At original cost:		
Plant in service—excluding land	919,598,013	823,936,163
Less accumulated depreciation	(244,852,718)	(225,141,848)
	674,745,295	598,794,315
Construction in progress	159,569,204	170,421,339
Land and land rights	13,548,198	13,511,222
Nonoperating property—net of accumulated depreciation	274,512	274,512
	848,137,209	783,001,388
TOTAL	$ 940,868,824	$ 885,796,826

See notes to financial statements.

LIABILITIES	2002	2001
CURRENT LIABILITIES:		
Accounts payable	$ 11,309,675	$ 6,484,749
Accrued payroll and payroll taxes payable	1,357,254	1,323,540
Compensated absences payable	481,700	334,344
Due to other City funds	2,879,828	2,896,446
Interest payable	7,925,208	8,079,195
Taxes payable	387,231	188,898
Claims payable	645,032	596,060
Revenue bonds due within one year	20,363,956	18,360,000
Public works trust loan due within one year	118,217	118,217
Deferred credits and other	584,000	696,060
	46,052,101	39,077,509
REVENUE BONDS:		
Revenue bonds—due serially	654,130,000	607,490,000
Less revenue bonds due within one year	(20,363,956)	(18,360,000)
Less bond discount and premium—net	(4,817,671)	(5,144,835)
Less deferred charges on advance refunding	(6,182,081)	(6,797,877)
	622,766,292	577,187,288
NONCURRENT AND OTHER LIABILITIES:		
Compensated absences payable—noncurrent	2,678,722	2,906,458
Public works trust loan	1,182,167	1,300,384
Claims payable	1,963,594	1,291,164
Environmental liability	1,225,633	1,300,000
Vendor deposits payable	676,460	945,575
Other	676,481	711,483
	8,403,057	8,455,064
Total liabilities	677,221,450	624,719,861
NET ASSETS:		
Invested in capital assets—net of related debt	262,152,705	259,318,696
Unrestricted	1,494,669	1,758,269
Total net assets	263,647,374	261,076,965
TOTAL	$ 940,868,824	$ 885,796,826

SEATTLE PUBLIC UTILITIES—WATER FUND

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2002 AND 2001

	2002	2001
OPERATING REVENUES:		
Direct service	$ 80,846,459	$ 72,891,449
Wholesale	35,787,617	30,936,018
Other	1,526,054	1,517,850
Total operating revenues	118,160,130	105,345,317
OPERATING EXPENSES:		
Resource management	8,312,131	9,035,739
Field operations	24,232,845	21,887,842
Engineering services	2,623,295	2,374,650
Customer services	8,075,049	7,701,374
General and administrative	10,652,161	10,736,150
City business and occupation taxes	7,867,504	7,157,162
Other taxes	3,928,747	3,705,544
Depreciation and amortization	25,171,216	23,748,307
Total operating expenses	90,862,948	86,346,768
NET OPERATING INCOME	27,297,182	18,998,549
OTHER INCOME (EXPENSES):		
Investment and interest income	1,147,940	2,206,350
Interest expense	(24,971,602)	(23,009,583)
Amortization of debt expenses	(258,957)	(238,849)
Loss on Tacoma Project	(6,636,051)	
Other—net	(175,146)	1,456,845
Total other expenses	(30,893,816)	(19,585,237)
CAPITAL AND OPERATING FEES, CONTRIBUTIONS, AND GRANTS:		
Capital fees, contributions, and grants	6,167,043	5,186,225
Operating fees, contributions, and grants		284,456
Total capital and operating fees, contributions, and grants	6,167,043	5,470,681
CHANGE IN NET ASSETS	2,570,409	4,883,993
NET ASSETS:		
Beginning of year	261,076,965	256,192,972
End of year	$263,647,374	$261,076,965

See notes to financial statements.

SEATTLE PUBLIC UTILITIES—WATER FUND

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2002 AND 2001

	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from customers	$ 116,333,305	$ 103,325,834
Cash paid to suppliers and employees	(50,320,223)	(52,956,312)
Cash paid for taxes	(10,994,246)	(10,949,947)
Net cash provided by operating activities	55,018,836	39,419,575
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES—Operating grants received		284,456
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Proceeds from the sale of bonds	64,923,517	53,109,459
Principal payments on revenue bonds	(18,360,000)	(17,595,000)
Debt issuance costs	(230,943)	(708,715)
Principal payment on public works trust loan	(118,217)	(118,217)
Acquisition and construction of utility plant and additions to deferred assets	(90,409,986)	(78,225,637)
Interest paid	(31,319,372)	(29,148,661)
Capital fees, contributions and grants	6,167,043	5,186,225
Cash received from disposal of capital assets		1,374,853
Net cash used in capital and related financing activities	(69,347,958)	(66,125,693)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investments		(33,578,241)
Proceeds from sale of investments	33,578,241	
Interest received on investments	1,147,938	2,206,350
Net cash provided by (used in) investing activities	34,726,179	(31,371,891)
NET INCREASE (DECREASE) IN CASH AND EQUITY IN POOLED INVESTMENTS	20,397,057	(57,793,553)
CASH AND EQUITY IN POOLED INVESTMENTS:		
Beginning of year	6,752,981	64,546,534
End of year	$ 27,150,038	$ 6,752,981

(Continued)

SEATTLE PUBLIC UTILITIES—WATER FUND

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2002 AND 2001

	2002	2001
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net operating income	$27,297,182	$18,998,549
Adjustments to reconcile net operating income to net cash provided by operating activities:		
Depreciation and amortization	25,171,216	23,748,307
Changes in operating assets and liabilities:		
Accounts receivable	(1,623,254)	(826,522)
Unbilled revenues	(632,050)	(730,231)
Due from other City funds	930,312	972,950
Due from other governments	(588,446)	(720,548)
Materials and supplies inventory	(318,450)	236,816
Current portion of notes and contracts receivable	(5,003)	(59,016)
Prepayments and other	(2,143)	5,376
Notes and contracts receivable	91,618	(656,117)
Environmental liability	(74,367)	(270,309)
Vendor deposits payable	(269,115)	(689,374)
Accounts payable	4,331,947	943,682
Accrued payroll and payroll taxes payable	33,714	393,794
Compensated absences payable	(80,380)	487,546
Due to other City funds	(16,618)	(1,905,109)
Claims payable	721,402	(1,015,058)
Other liabilities	51,271	504,839
Total adjustments	27,721,654	20,421,026
NET CASH PROVIDED BY OPERATING ACTIVITIES	$55,018,836	$39,419,575

See notes to financial statements. (Concluded)

1. OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Operations—The City of Seattle, Seattle Public Utilities—Water Fund (the "Fund") is a public utility enterprise fund of the City of Seattle (the "City"). On January 1, 1997, the City created Seattle Public Utilities ("SPU"), which brought together under one administrative umbrella the Water, Solid Waste, and Drainage and Wastewater functions of the City as well as certain engineering functions. The Fund (as well as the other funds) remains separate for accounting purposes. SPU receives certain services from other departments and agencies of the City, including some that are normally considered to be general and administrative. The Fund is charged a share of these costs and additionally pays a business and occupation tax to the City's General Fund. Water services provided by the Fund to other City departments and agencies are billed at rates prescribed by City ordinances. Under direction of the Seattle City Council, no charges are made to the City for water services for public fire protection.

SPU provides customer service for, and the cost is shared among, SPU's three utility funds (Water, Drainage and Wastewater, and Solid Waste) and Seattle City Light ("SCL"). In addition, SPU also performed utility billing for each of these entities until early 2001, when SCL implemented its new billing system, Combined Customer Service System, and began performing the utility billing service for each of the entities. Instead of billing each other for the two operating services, SPU and SCL made an arrangement to exchange the services. The Fund provided services to SCL with a cost of $1,033,601 in 2002 and $990,255 in 2001. In return, the Fund received services from SCL with a cost of $994,998 in 2002 and $773,840 in 2001.

The Fund is subject to regulation by the City and the state of Washington. Service rates are authorized by ordinances passed by the City Council. Accounting policies and financial reporting are regulated by the Washington State Auditor's Office, Division of Municipal Corporations and conform to accounting principles generally accepted in the United States of America as applied to governmental units. The Governmental Accounting Standards Board ("GASB") is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. The Fund has chosen to apply all pronouncements and interpretations issued by the GASB, as well as those issued by the Financial Accounting Standards Board on or before November 30, 1989, except when they conflict with the GASB.

Basis of Accounting—The Fund is accounted for on a flow of economic resources measurement focus. Its financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to governmental units using the accrual basis of accounting. With the flow of economic resources measurement focus, all assets and liabilities associated with the Fund's operations are included on the balance sheets. The operating statements present increases (revenues) and decreases (expenses) in total net assets.

Revenues—The Fund provides water service to wholesale and retail customers and recognizes revenue when such service is provided. Wholesale customers (Purveyors) are under contract with the Fund and rates are set based on cost allocation criteria stipulated in the contracts.

Service rates for all customers are authorized by ordinances passed by the Seattle City Council. Billings are made to customers monthly or bimonthly. Revenues for water sold to customers between the last billing date and the end of the year are estimated and accrued in the accompanying financial statements.

Utility Plant**—**Utility plant is stated at cost or, if contributed, at fair value at the date of contribution. Costs include direct material, labor, and indirect costs such as engineering, supervision, payroll taxes, pension benefits, and interest relating to the financing of projects under construction. The cost of current repairs and maintenance is charged to expense, while the cost of replacements and betterments is capitalized. The Fund's policy is to capitalize assets with a cost of $5,000 or more. At the time property is retired and removed from service, the original cost of the property, together with removal cost less salvage value, is charged to the depreciation reserve.

Depreciation**—**Plant in service is depreciated on the straight-line method, using composite rates based on estimated lives as follows:

Earthen source of supply developments	100 years
Transmission and distribution reservoirs, tanks, and mains	50 to 100 years
Pumps, wells, and treatment facilities	15 to 33 years
Buildings, fixtures, and equipment	3 to 50 years

It is the Fund's policy to begin recording depreciation in the year following acquisition and to record a full year's charge in the year of disposition.

Construction in Progress**—**Capitalizable costs incurred on projects which are not in use or ready for use are held in construction in progress. When the asset is ready for use, related costs are transferred to utility plant. Upon determining that a project will be abandoned, the related costs are charged to expense.

Deferred Conservation Costs**—**Conservation program costs that result in long-term benefits and reduce or postpone other capital expenditures are capitalized and amortized over their expected useful lives of 10 years, commencing when each program is in place. Costs of administering the overall program are expensed as incurred.

Deferred Computer Systems Costs**—**The Fund capitalizes all direct and incremental costs and the related overhead incurred in connection with the development of significant information systems projects that are to be used internally. Such costs are shown as other deferred charges on the balance sheets and are amortized over the projects' estimated useful life, usually six to eight years. In 2001, the Fund put a computer system, the Consolidated Customer Service System ("CCSS"), in service. Deferred CCSS costs of $9,438,452 are being amortized for eight years beginning in 2002.

Preliminary Survey Investigation Costs**—**The Fund defers costs associated with preliminary survey investigations and feasibility studies within other deferred charges on the balance sheets and amortizes those costs either over the periods for which they are included in rates or over the estimated economic life of the study. In the event of abandonment of a project, all associated costs are charged to expense.

Environmental Liability Cleanup Costs**—**In the ordinary course of conducting its business, the Fund incurs liabilities related to the cleanup of certain environmental contaminants. The Fund's policy is to recognize the expense associated with the cleanup over those periods in which the costs are recovered through rates.

Rate Stabilization Account**—**The Rate Stabilization Account (the "Account") was established in 1993 to reduce year-to-year variation in rates. Deposits into the Account are included as revenue within the statements of revenues, expenses, and changes in net assets and are excluded as revenue available for debt service coverage in the year the deposit is made. Conversely, moneys withdrawn from the Account are considered revenue available for debt service coverage in the year the withdrawal is made. Effective in 2003, a City ordinance requires the Fund to make an annual deposit of $2.5 million into the Account, and withdrawals from the Account must be authorized by City ordinance.

***Timber Sales*—**The Fund occasionally contracts with outside timber purchasers to harvest timber owned within its watershed and nonoperating properties. Revenue is recognized based on terms of the harvesting contract. The cutting schedules and associated revenues and expenses are primarily determined by market and other factors. Income arising from timber operations may vary significantly from year to year.

Net revenues from commercial thinning, salvage, and timber harvest in the Cedar River Watershed are obligated, in compliance with City ordinance, to support land and habitat acquisition within the watershed.

***Compensated Absences*—**Employees earn vacation based on their date of hire and years in service, and may accumulate earned vacation up to a maximum of 480 hours. Unused vacation at retirement or normal termination is considered vested and payable to the employee. Earned but unused vacation is accrued as a liability of the Fund.

Employees also earn up to 12 days of sick leave per year and may accumulate sick leave balances without limit. Employees are paid 25% of the value of unused sick leave upon retirement. They are not paid for unused sick leave if they leave before retirement. The Fund records a liability for estimated sick leave payments.

***Taxes*—**The Fund is charged a business and occupation tax by the City at a rate of 10% of Fund revenues, net of certain credits. In addition, the Fund paid a public utility tax to the state based on approximately 4% of a certain portion of revenues. The remainder was taxed under the business and occupation tax at the rate of 1.5% in 2002 and 2001.

***Inventory*—**The Fund values its inventory based on a moving average method. The most recent total cost of an inventory item is divided by the total units of the item that remain in the inventory to determine the moving average cost of the item. The moving average cost is then applied to all the units of the inventory item.

***Net Assets*—**There are three components of net assets: invested in capital—net of related debt; restricted net assets; and unrestricted net assets. Invested in capital assets includes utility plant, deferred conservation costs, other deferred charges that are capital in nature, and net unamortized bond issuance costs. The Fund had no restricted assets as of December 31, 2002 and 2001.

***Other Revenues and Expenses*—**This includes the nonoperating revenues and expenses that arise from transactions not related directly to the major income-earning operations of the utility and are of a recurring nature. Major items are investment and interest income, interest expense, and amortization of debt expenses.

***Arbitrage Rebate Requirement*—**The Fund is subject to the Internal Revenue Service Code, Section 148(f), related to its tax-exempt revenue bonds. The Internal Revenue Service Code requires that earnings on gross proceeds of any revenue bonds, which are in excess of the amount prescribed, will be rebated to the Internal Revenue Service. As such, the Fund would record such rebate as a liability.

***Accounting Changes*—**In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. GASB Statement No. 34, as amended, commonly referred to as the new reporting model, retained much of the old reporting and disclosure requirements under the prior reporting model with certain modifications and newly added information. Applicable portions of this statement were implemented by the Fund for the year ended December 31, 2002, and the most significant effects on the

Fund's annual financial statements were the addition of management's discussion and analysis as required supplementary information and reclassifications of net asset amounts.

The Fund adopted GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, in 2001. The cumulative effect of the adoption was made in 2002 in conjunction with the implementation of GASB Statement No. 34 by classifying as unrestricted net assets the amounts previously reported as contributions in aid of construction.

Use of Estimates**—**The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements. Estimates and assumptions are used to record unbilled revenues, allowance for doubtful accounts, accrued sick leave, environmental liabilities, and other contingencies. Changes in these estimates and assumptions may have a material impact on the financial statements.

Reclassifications**—**Certain reclassifications have been made to prior year balances to provide a presentation consistent with the current year.

2. CASH AND EQUITY IN POOLED INVESTMENTS AND INVESTMENTS

The City's Department of Finance invests all temporary cash surpluses for City departments. This department may, at various times, invest these surpluses in certificates of deposit issued by Washington State depositories that participate in a state insurance pool, U.S. Treasury and agency securities, prime bankers' acceptances trading in the secondary market, and repurchase or reverse-repurchase agreements with primary dealers that use authorized securities as collateral. Delivery of collateral on the underlying securities is required on all repurchase agreement transactions. The Fund is allocated interest income by the City.

It is the City's policy that all investments of the Fund, except repurchase or reverse-repurchase agreements, be held by banks or trust companies as agents of the City and in the City's name.

The first $100,000 of bank deposits are federally insured. The Washington State Public Deposit Protection Commission ("PDPC") collateralizes deposits in excess of $100,000. The PDPC is a multiple financial institution collateral pool. There is no provision for the PDPC to make additional pro rata assessments if needed to cover a loss. Therefore, the PDPC protection is of the nature of collateral, not of insurance.

The City considers highly liquid, short-term investments with original maturities of three months or less to be cash equivalents. The cash pool operates like a demand deposit account in that all agencies, including the City, may deposit cash at any time and can also withdraw cash out of the pool without prior notice or penalty. Accordingly, the statements of cash flows reconcile to cash and equity in pooled investments plus the cash held in escrow for vendors. Securities with maturities exceeding three months at the time of purchase are reported at fair value on the balance sheets; the net increase (decrease) in the fair value of those investments is reported as part of investment income.

Capital expenditures are initially funded by the Operating Fund, which is subsequently reimbursed by the Construction Fund.

Investments are reported at fair value based on quoted market prices for those or similar securities. There were no investments as of December 31, 2002. As of December 31, 2001, investments were as follows:

U. S. government securities	$ 16,867,846
Commercial paper	16,710,395
	$ 33,578,241

3. NOTES AND CONTRACTS RECEIVABLE

Other receivables are composed of the following as of December 31:

	2002	2001
Water main assessments	$ 357,378	$ 368,378
Land sales receivable	233,839	272,454
Richmond Beach surcharge	210,414	247,414
	801,631	888,246
Less current portion	(91,618)	(86,615)
Total other receivables, net of current portion	$ 710,013	$ 801,631

4. UTILITY PLANT

Utility plant consists of the following as of December 31:

	2001	Additions and Transfers In	Retirements and Transfers Out	2002
Equipment	$ 713,242,030	$ 71,241,592	$ (35,860)	$ 784,447,762
Buildings, fixtures, and grounds	110,694,133	24,729,974	(273,856)	135,150,251
Total plant in service—excluding land	823,936,163	95,971,566	(309,716)	919,598,013
Less accumulated depreciation	(225,141,848)	(19,710,870)		(244,852,718)
	598,794,315	76,260,696	(309,716)	674,745,295
Construction in progress	170,421,339	99,618,604	(110,470,739)	159,569,204
Land and land rights	13,511,222	36,976		13,548,198
Nonoperating property—net of accumulated depreciation	274,512			274,512
Utility plant—net	$ 783,001,388	$ 175,916,276	$ (110,780,455)	$ 848,137,209

During 2002 and 2001, the Fund capitalized interest costs relating to construction of $7,213,226 and $7,524,877, respectively.

5. OTHER DEFERRED CHARGES

Other deferred charges consist of the following as of December 31:

	2002	2001
Capitalized information systems costs	$52,346,882	$50,381,422
Environmental liability costs	2,534,432	2,534,432
Intangible assets	1,345,782	1,194,051
Preliminary investigation costs	1,170,476	1,170,476
Less accumulated amortization	(35,059,979)	(31,247,004)
	$22,337,593	$24,033,377

6. REVENUE BONDS

At December 31, revenue bonds consist of the following:

	2002			2001		
	Long-Term	Short-Term	Total	Long-Term	Short-Term	Total
2002 A&B Water System Revenue Bonds, rates averaging 1.29% in 2002, due through 2032, insured by a third-party insurer	$ 63,841,044	$ 1,158,956	$ 65,000,000	$ –	$ –	$ –
2001 Water System Revenue Bonds, 4.50% to 5.00%, due through 2031, insured by a third-party insurer	52,525,000		52,525,000	52,525,000		52,525,000
1999B Water System Revenue Bonds, 5.00% to 6.00%, due through 2029, insured by a third-party insurer	104,600,000	1,875,000	106,475,000	106,475,000	1,800,000	108,275,000
1999A Water System Revenue Bonds, 4.00% to 5.375%, due through 2029, insured by a third-party insurer	93,320,000	1,765,000	95,085,000	95,085,000	1,700,000	96,785,000
1998 Water System Revenue Bonds, 4.5% to 5.0%, due through 2027, insured by a third-party insurer	72,805,000	1,560,000	74,365,000	74,365,000	1,495,000	75,860,000
1997 Water System Revenue Bonds, 5.375% to 5.625%, due through 2026, insured by a third-party insurer	46,915,000	1,065,000	47,980,000	47,980,000	1,020,000	49,000,000
Brought forward	434,006,044	7,423,956	441,430,000	376,430,000	6,015,000	382,445,000

	2002			2001		
	Long-Term	**Short-Term**	**Total**	**Long-Term**	**Short-Term**	**Total**
Carried forward	$434,006,044	$ 7,423,956	$441,430,000	$376,430,000	$ 6,015,000	$382,445,000
1995 Water System Revenue Bonds, variable rates averaging 1.25% in 2002, due through 2025, insured by a third-party insurer	40,700,000	1,100,000	41,800,000	41,800,000	1,100,000	42,900,000
1993 Water System Revenue Bonds, 4.7% to 5.5%, due through 2023, insured by a third-party insurer	159,060,000	11,840,000	170,900,000	170,900,000	11,245,000	182,145,000
	$633,766,044	$20,363,956	$654,130,000	$589,130,000	$18,360,000	$607,490,000

In May 2002, the Fund issued $65,000,000 of Water System Revenue Bonds with principal payment due in 2032 and an annual interest rate of 1.29% in 2002. It is the Fund's policy to make annual principal payments to reduce the outstanding principal amount, beginning in 2003.

The 1995 Water System Revenue Bonds and the 2002 Water System Revenue Bonds are variable rate obligations. The Fund has secured the services of remarketing agents responsible for remarketing the bonds at regular intervals on the open market. The Fund pays actual market interest costs and a fee for remarketing services. The bonds are currently remarketed weekly, though the Fund retains the ability to cause the bonds to be remarketed at other intervals.

In prior years, the Fund defeased certain bonds by placing investments acquired from the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust accounts and the defeased bonds are not included in the Fund's financial statements. The difference between the cost to defease outstanding debt and the carrying value of bonds defeased by refunding bonds is deferred and amortized over the shorter of the remaining term of the refunded bonds or the term of the refunding bonds, using the effective interest method.

Proceeds of the revenue bonds are being used to finance certain capital improvement projects and conservation programs for the Fund.

Future principal and estimated interest payments for revenue bonds are as follows:

Years Ending December 31	Principal	Interest	Total
2003	$ 20,363,956	$ 33,259,026	$ 53,622,982
2004	21,340,315	32,277,848	53,618,163
2005	18,328,527	31,208,880	49,537,407
2006	18,188,668	30,297,971	48,486,639
2007	16,040,815	29,362,989	45,403,804
2008 – 2012	94,467,274	133,604,119	228,071,393
2013 – 2017	121,321,912	106,254,277	227,576,189
2018 – 2022	152,665,030	71,608,635	224,273,665
2023 – 2027	135,249,298	33,151,690	168,400,988
2028 – 2032	56,164,205	5,327,535	61,491,740
	$ 654,130,000	$ 506,352,970	$ 1,160,482,970

Water System Revenue Bonds contain certain financial covenants, the most significant of which requires the Fund to maintain adjusted net revenue to provide for debt service coverage on the bonds and a reserve for the payment of annual debt service. The Fund must maintain adjusted net revenue of not less than 125% of actual annual senior lien debt service. Adjusted net revenues remaining after senior lien debt service has been paid must not be less than 125% of annual junior lien debt service. In 2002, adjusted net revenue was 151% of senior lien debt service, and adjusted net revenue available after senior lien debt service was paid was 1111% of junior lien debt service. The Fund has obtained reserve insurance policies to meet its reserve requirements. Net revenues available for debt service for the year ended December 31, 2002, is determined as follows:

Change in net assets	$ 2,570,409
Add:	
City occupation tax	7,867,504
Depreciation and amortization	25,171,216
Interest on revenue bonds	31,165,386
Amortization of debt expenses and loss	1,278,400
Claims and damages not paid in 2002	721,402
Noncash investment fair value adjustment	(204,319)
Loss on Tacoma Project	6,636,051
Withdrawal of cash from the Rate Stabilization Account	3,000,000
	78,206,049
Less capitalized interest	7,213,226
Adjusted net revenue available for debt service	$ 70,992,823
Senior debt service requirement (cash basis)	$ 47,116,045
Senior lien coverage percentage	151 %
Adjusted net revenue available for junior lien debt service	$ 23,876,778
Junior lien debt service requirement (cash basis)	2,149,126
Junior lien coverage percentage	1,111%

7. PUBLIC WORKS TRUST LOAN

During 1993, the Fund entered into an agreement to borrow up to $2,220,000 from the Washington State Department of Community Development under its Public Works Trust Loan Program for the construction of certain capital improvements. As of December 31, 2002 and 2001, the Fund owed $1,300,384 and $1,418,601, respectively. Amounts borrowed under the agreement accrue interest at 1% per annum and are to be repaid in 19 equal annual installments, plus interest.

8. ENVIRONMENTAL LIABILITY

The Fund has recorded a $1,225,633 liability for future environmental cleanup costs related to lead-based paint and arsenic contamination surrounding several standing water tanks as well as expected remediation efforts associated with underground fuel tank replacements. The liability is included in other long-term liabilities on the balance sheet. The total cost is expected to be recovered through rates over an estimated 30-year period.

The schedule below represents the changes in the estimated liability:

	2002	2001
Beginning liability	$ 1,300,000	$ 1,970,989
Payments	(74,367)	(670,989)
Ending liability	$ 1,225,633	$ 1,300,000

9. TACOMA PROJECT

The Tacoma Project originated in the 1980s. The project concept was to bundle the construction of a pipeline connecting Seattle and Tacoma with the expansion of Tacoma's transmission and Green River supply systems. The Fund agreed to pay one-third of the project cost in exchange for a portion of the increased water supply. Design, engineering, permitting, and environmental analyses began in 1992. The Fund capitalized its share of these costs as construction in progress.

During 2001, it became apparent that Lake Tapps, a water reservoir in Pierce County used for power generation, could be developed as a source of water supply. The lake contains treated wastewater and glacial till and is of lower quality than that supplied by Tacoma's Green River source or Seattle's sources. As a matter of policy, the Fund requires control of the sources of water with which it will supply its customers. The Fund was unable to secure a guarantee that water supplied to Seattle from the Tacoma Project would come exclusively from Tacoma's Green River source (and not from Lake Tapps), and therefore will not continue as a partner in this project.

The Fund's costs for Tacoma Project development were for planning, design, environmental review and permitting activities, and not for physical assets. Because the Fund will not participate in the Tacoma Project, the Fund recorded a loss on the Tacoma Project in 2002 in the amount of $6,636,051.

10. RETIREMENT PLANS

***Pension Costs*—**All permanent Fund employees are eligible to participate in the Seattle City Employees' Retirement System (the "System"), a cost-sharing public employee retirement system operated by the City. Benefits vest after five years of covered service. City employees may retire after 30 years of service regardless of age; after age 52, with 20 or more years of service; after age 57, with 10 or more years of service; and after age 62, with five or more years of service. The System also provides death and disability benefits. These benefit provisions and all other requirements are established by City ordinances.

City employees are required to contribute 8.03% of their annual base salaries to the System. The City's contribution rate was 8.03% as of January 1, 2002 and 2001. Employer rates are established by the City Council on a biannual basis. The Fund's contributions to the System for the years ended December 31, 2002, 2001, and 2000, were $2,665,945, $2,461,551, and $2,357,781, respectively. The Fund's contribution in 2002 represents its full liability to the System.

The System issues stand-alone financial statements, which may be obtained by writing to the Seattle City Employees' Retirement System, 801 Third Avenue, Suite 300, Seattle, Washington, 98104; telephone: (206) 386-1292.

Employer contributions for the City are as follows (dollars in millions):

Year Ended December 31	City Required Contribution	City Actual Contribution	Percentage Contributed
2000	$ 30.8	$ 30.8	100 %
2001	32.5	32.5	100
2002	35.2	35.2	100

Actuarial data and assumptions:	
Valuation date	January 1, 2002
Actuarial cost method	Entry age
Amortization method	Level percent
Remaining amortization period	-0- years
Amortization period	Open
Asset valuation method	Market
Investment rate of return	8.00%
Projected general wage inflation	4.50%
Postretirement benefit increases	0.67%

Schedule of funding progress (dollars in millions):

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liabilities (AAL) — Entry Age (b) (1)	Unfunded AAL (UAAL) (b-a) (2)	Funded Ratio (a/b)	Covered Payroll (c) (3)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
1/1/2000	$ 1,582.7	$ 1,403.1	$ (179.6)	112.8 %	$ 370.4	(48.5)%
1/1/2001	1,493.1	1,490.3	(2.8)	100.2	383.7	(0.7)
1/1/2002	1,383.7	1,581.4	197.7	87.5	405.1	48.8

(1) Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method
(2) Actuarial accrued liabilities less actuarial value of assets
(3) Covered payroll includes compensation paid to all active employees on which contributions are calculated

***Deferred Compensation*—**The City offers all of its employees a deferred compensation plan (the "Plan") created in accordance with Internal Revenue Code ("IRC") Section 457. The Plan permits employees to defer a portion of their salaries until future years. The deferred compensation is paid to employees upon termination, retirement, death or unforeseen emergency.

The Plan is an eligible deferred compensation plan under Section 457 of the IRC of 1986, as amended, and a trust exempt from tax under IRC Sections 457(g) and 501(a). The Plan is operated for the exclusive benefit of participants and their beneficiaries. No part of the corpus or income of the trust shall revert to the City or be used for, or diverted to, purposes other than the exclusive benefit of participants and their beneficiaries.

The Plan is not reported in the financial statements of the City or the Fund.

It is the opinion of the City's legal counsel that the City has no liability for investment losses under the Plan. Under the Plan, participants select investments from alternatives offered by the Plan Administrator, who is under contract with the City to manage the Plan. Investment selection by a participant may be changed from time to time. The City does not manage any of the investment selections. By making the selection, participants accept and assume all risks inherent in the Plan and its administration.

11. RISK FINANCING LIABILITIES

The City and the Fund are self-insured for certain losses arising from personal and property damage claims by third parties and for casualty losses to the Fund's property. Liabilities for identified claims and claims incurred but not reported have been recorded by the Fund.

For 2002 and 2001, liabilities for workers' compensation claims as well as other claims are discounted over a 15-year period at the City's rate of return on investments, 4.24% and 5.34%, respectively. Claims expected to be paid within one year were $645,032 and $596,060 at December 31, 2002 and 2001, respectively. The schedule below represents the changes in the liability for workers' compensation claims and other claims (risk-financing liabilities) as of December 31:

	2002	2001
Beginning liability	$ 1,887,224	$ 2,902,282
Payments	(516,300)	(2,142,911)
Incurred claims and changes in estimates	1,237,702	1,127,853
Ending liability	$ 2,608,626	$ 1,887,224

12. COMMITMENTS AND CONTINGENCIES

Seattle Public Utilities has prepared a comprehensive environmental management plan for its Cedar River Watershed. The purpose of the Habitat Conservation Plan ("HCP") is to protect all species of concern that may be affected by the operations of Seattle Public Utilities and City Light in the Cedar River Watershed, while allowing the City to continue to provide high quality drinking water to the region. The federal government has accepted the HCP. The total cost of implementing the HCP is expected to be $90 million (in 2002 dollars) over a period of 50 years. Expenditures are expected to be funded from a combination of operating revenues and debt.

The Fund has negotiated an agreement relating to compliance with the Surface Water Treatment Rule on its Cedar River supply system, which requires it to evaluate ozonation and filtration, and recommend changes to current treatment. A recommendation for ozonation compatible with filtration was provided to the Washington State Department of Health in November 1995, and approved in January 1996. The ozonation facility is under construction and expected to cost approximately $100 million, of which $42.4 million is expected to be paid in 2003 and 2004. The facility is expected to be operational in 2004. Expenditures are expected to be funded from a combination of operating revenues and debt.

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